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Does the Principal Purpose Test (PPT) Throw Tax Certainty to the Winds?

Ashish Goel (Advocate) · Thursday, May 2nd, 2019

In 1789, Benjamin Franklin wrote in a letter to French scientist Jean-Baptiste Leroy: "Our new Constitution is now established, and has an appearance that promises permanency; but in this world nothing can be said to be certain, except death and taxes."

Franklin was right then and he is right now. However, there is one more commonality between death and taxes, which Franklin probably failed to notice: one does not know when, how and where one is going to be taxed just like when, how and where one is going to die.

In 2013, in the wake of the global financial crisis, the OECD launched the BEPS project to fill certain gaps in the existing international tax system. The idea was to ensure that multinational corporations pay the right amount of tax, at the right place, and at the right time.

According to the OECD, treaty abuse, particularly treaty shopping, is one of the ways in which companies indulge in BEPS activities. And the OECD, as part of Action 6 of the BEPS project, recommended measures to tackle treaty abuse, including the incorporation of a 'principal purpose test' in tax treaties.

A lot has been written about the PPT ever since the OECD proposed it: both in favor and in opposition. The bare text of the PPT is set out in Article 7 of the Multilateral Instrument (MLI), which is aimed at implementing the tax-treaty related BEPS measures.

India signed the BEPS MLI in June 2017 and, as per media reports; the government is most likely to ratify the MLI in 2019. Articles of the MLI will then have legal force and be considered to be a part and parcel of India's tax treaties (that is, those covered under the MLI).

As a tax lawyer interested in constitutional law, I am tempted to wonder if the bare text of Article 7 makes it constitutionally suspect. Of course, there is no one standard answer to this question and many scholars have expressed their differing views from time to time. I can only hint at some of the answers but, in this blog, I instead would like to draw the readers' attention to some of the underlying questions.

Article 7 of the MLI states:

"*Notwithstanding* the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income or capital if it is *reasonable to conclude*, having regard to all *relevant facts and circumstances*, that obtaining that benefit was *one of the principal purposes* of any arrangement or transaction that resulted directly or indirectly in that benefit, *unless it is established* that granting that benefit in these circumstances *would be in accordance with the object and purpose* of the relevant provisions of this Convention."

The Article is no doubt broad and vague. In principle, no tax can be levied except without the authority of law and such a law cannot be in violation of the basic principles on which the Constitution is founded. One such principle is adherence to the rule of law, which includes in its ambit certainty in application and implementation of the law.

In tax matters specifically, the Indian Supreme Court elaborated on the importance of certainty in tax law as well as the rule of law in the oft-cited case of *Vodafone International Holdings vs. Union of India*. There, Justice Kapadia observed:

"*FDI flows towards location with a strong governance infrastructure which includes enactment of laws and how well the legal system works. Certainty is integral to rule of law. Certainty and stability form the basic foundation of any fiscal system. Tax policy certainty is crucial for taxpayers (including foreign investors) to make rational economic choices in the most efficient manner*."

"*Legal doctrines like 'limitation of benefits' and 'look through' are matters of policy. It is for the Government of the day to have them incorporated in the Treaties and in the laws so as to avoid conflicting views. Investors should know where they stand. It also helps the tax administration in enforcing the provisions of the taxing laws*," he continued.

The Supreme Court's decision in *Vodafone* pre-dates the OECD's BEPS project. In fact, in the decision itself, the court noted that anti-abuse provisions cannot be read into tax treaties and deferred to the Parliament in making tax treaty policy.

This position was largely in line with the decade-old decision handed down in *Azadi Bachao Andolan vs. Union of India*. In both cases, the Supreme Court noted that the Parliament should introduce adequate provisions in domestic law or in tax treaties to ensure companies do not exploit tax rules to their benefit.

Of course, it is none's case that there should not be an anti-abuse rule in tax treaties. In fact, such a rule is not only desirable but also absolutely necessary to allay concerns about tax treaty override in case of domestic anti-abuse rules. The existence of a treaty abuse rule and meeting its requirements would in fact be a good defense against the use of a domestic anti-abuse rule.

However, such rules must not be arbitrary and vague and must conform to the principle of tax certainty and fairness. The PPT does not seem to be like one.

As noted by the Indian Supreme Court in *Chief Settlement Commissioner vs Om Prakash* (1968), "in our constitutional system, the central and most characteristic feature is the concept of the rule of law which means the authority of the courts to test all administrative actions by the standard of legality."

In many cases in the past, the Indian judiciary has clearly held that the tax authority cannot act in an arbitrary and whimsical manner. Any action on the part of the tax authority must be sound and based on reason.

That laws must be certain and predictable in application is a universal principle, applicable even in non-tax matters. For instance, Justice Srivastava in the *State of MP vs. B L Kaul* (1999) famously remarked: “if a decision is taken without any principle or without any rule, it is unpredictable and such a decision is always antithesis of a decision taken in accordance with law. The rule of law implies taking a decision by applying known principles.”

Under the PPT, the tax authority may deny tax benefits if it is *reasonable to conclude*, having regard to all *relevant facts and circumstances*, that obtaining that benefit was *one of the principal purposes* of any arrangement or transaction that resulted directly or indirectly in that benefit.

It is not only necessary that the tax authority’s conclusions be reasonable, but there has to be a sound basis for the conclusions arrived at. These conclusions cannot be drawn based on the subjective satisfaction of the tax authority but only on objective, clearly spelt-out factors.

The problem with the PPT is who decides what are ‘relevant facts” and “relevant circumstances”: certainly, not the taxpayer. What is the standard of “reasonableness”? And “reasonableness” from whose eyes? And how does the tax authority come to a finding that, upon perusal of the relevant facts and circumstances, it indeed appears to be a reasonable or unreasonable case? Where is the guidance?

Next, the tax authority may deny treaty benefits if one of the principal purposes – and not *the* principal purpose – was to obtain tax benefit. There is no illustrative list of instances that explain when a transaction can be said to have been carried out with a ‘principal’ purpose to obtain tax benefit. This means that the PPT would still apply if genuine commercial reason was also one of the principal purposes of the transaction. Here again, is it not tad too easy for the tax authority to show that tax benefit was one of the principal purposes?

Additionally, the wording of Article 7 states that treaty benefit will not be denied if it is established that granting that benefit would be in accordance with the object and purpose of the tax treaty. What are the considerations that the court would examine to determine if the tax authority has discharged its burden of proof? Should the primary burden of proof in revenue matters fall on the taxpayer? Will the court look at the Preamble of the tax treaty or an individual treaty Article, or both? What if a tax treaty does not specifically disallow treaty shopping?

Pertinently, the PPT is much broader than the Indian GAAR: GAAR uses the main purpose test. Besides, the safeguards available under the Income Tax Act before invoking GAAR are not available in case of the PPT. There is a possibility, therefore, that the tax authority might wrongly invoke the PPT even in transactions otherwise within the spirit of the law.

These are some of the important factors that make the PPT broad and uncertain, which gives the tax authority a free hand to apply the anti-abuse rule. This is worrisome especially given that the PPT is being introduced through the MLI as developed by the OECD of which India is not a member. In fact, and as we might see in near future, the tax authority may play a quasi-legislative function in applying the PPT. The consequence: more uncertainty and more tax disputes.

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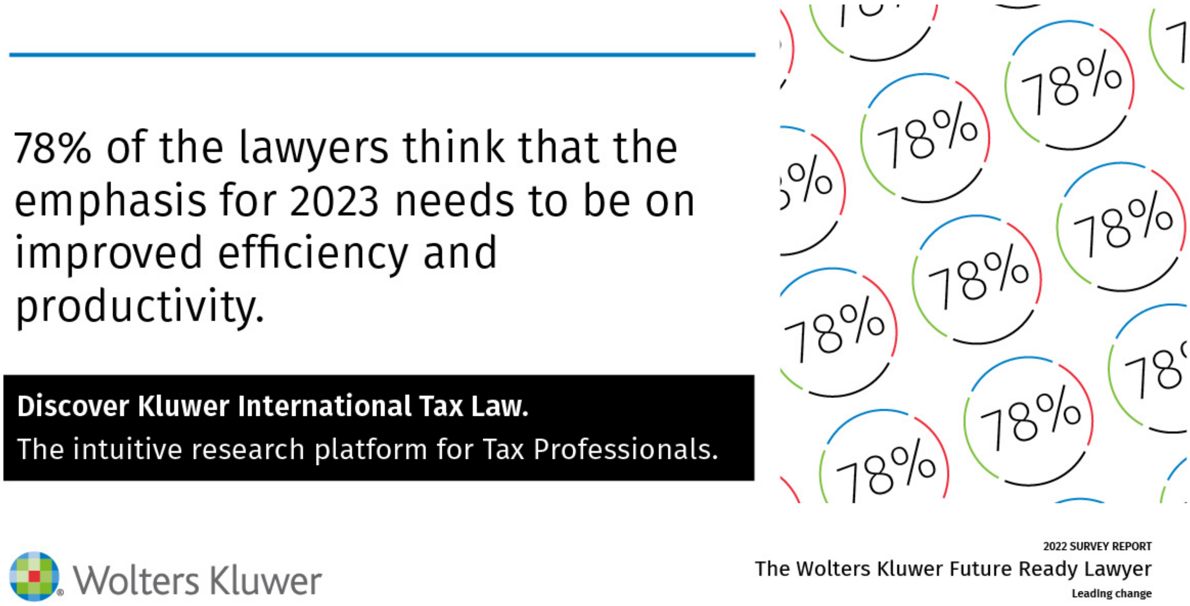

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